2005 BNH 006 **Note: This is an unreported opinion. Refer to AO 1050-1 regarding citation.**

UNITED STATES BANKRUPTCY COURT
DISTRICT OF NEW HAMPSHIRE

In re:

Timothy Jarvis,
Debtor

Bk. No. 04-10806-JMD
Chapter 7

Ready Productions, Inc.,
Plaintiff

v.

Adv. No. 04-01097-JMD

Timothy Jarvis,
Defendant

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MEMORANDUM OPINION

I. INTRODUCTION

Ready Productions, Inc. (the "Plaintiff"), commenced this adversary proceeding against Timothy Jarvis (the "Debtor") seeking a determination that a settlement agreement (the

"Agreement") that resolved prepetition litigation between the parties is not an executory contract, and seeking injunctive relief against the Debtor under the provisions of the Agreement. If the Agreement is not an executory contract, the Debtor may not reject it under 11 U.S.C. § 365.[1] Both parties have moved for summary judgment on Count I of the complaint.

This Court has jurisdiction of the subject matter and the parties pursuant to 28 U.S.C. §§ 1334 and 157(a) and the "Standing Order of Referral of Title 11 Proceedings to the United States Bankruptcy Court for the District of New Hampshire," dated January 18, 1994 (DiClerico, C.J.). This is a core proceeding in accordance with 28 U.S.C. § 157(b).

II. FACTS

The Agreement was entered into in February 2003 as part of the resolution of prepetition litigation between the parties,[2] in which the Debtor sued the Plaintiff, his ex-employer, seeking clarification of the provisions of certain non-competition agreements between them. Soon after the Agreement was entered into, Plaintiff initiated a suit[3] (the "Civil Action") seeking injunctive relief and recovery of damages for Debtor's alleged breach of the Agreement. On March 10, 2004, after discovery in the Civil Action, but before the trial date, the Debtor filed for bankruptcy protection. On April 15, 2004, Debtor filed a Motion to Amend Schedule G to list the Agreement as an executory contract and to File Debtor's Intent to Reject Executory Contract (the "Amendment") (Doc. No. 15 in the main case). In response to the Amendment, Plaintiff filed its complaint, commencing this adversary proceeding. Count I of the complaint seeks a

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[1] Unless otherwise indicted, all references to "section" or "§" refer to Title 11 of the United States Code.

[2] Suffolk Superior Court, Civil Action No. 02-4410-BLS.

[3] Suffolk Superior Court, Civil Action No. 03-4389-BLS.

declaration that the Agreement is not an executory contract and, therefore, cannot be rejected under § 365 of the Bankruptcy Code. The Plaintiff also argues that even if the Agreement is an executory contract, only the chapter 7 trustee has the authority to assume or reject an executory contract. Count II asks that the Debtor be enjoined from violating the Agreement.

On October 15, 2004, the Plaintiff filed a Motion for Summary Judgment on Count I of Its Complaint (Doc. No. 26) ("Plaintiff's MSJ"). On November 15, 2004, the Debtor filed his Objection and Cross-Motion for Summary Judgment (Doc. No. 31) ("Debtor's MSJ").[4] On December 20, 2004, after a hearing on the cross-motions for summary judgment, the Court took the matter under advisement.

III. DISCUSSION

A. The Summary Judgment Standard

An order granting summary judgment is proper if "the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law." Fed. R. Civ. P. 56(c), made applicable to adversary proceedings by Fed. R. Bankr. P. 7056; see also Barbour v. Dynamics Research Corp., 63 F.3d 32, 36 (1st Cir. 1995). When considering summary judgment, the court should draw all reasonable inferences from the facts in the manner most favorable to the non-movant. See Desmond v. Varrasso (In re Varrasso), 37 F.3d 760, 763 (1st Cir. 1994).

The Court is deciding the MSJ Motions without a stipulated factual record. Therefore, the Court may not resolve any factual disputes between the parties. Boston Five Cents Sav. Bank v.

[4] The "Plaintiff's MSJ" and the "Debtor's MSJ" shall be collectively referred to as the "MSJ Motions".

Dep't of Hous. & Urban Dev., 768 F.2d 5, 11-12 (1st Cir. 1985) citing Country Gas Serv., Inc. v. United States, 405 F.2d 147, 149 (1st Cir. 1969)) (on appeal from a summary judgment, the only question is whether the allegations of the party against whom it is rendered were sufficient to raise a material factual dispute). "[A]t the summary judgment stage the judge's function is not himself to weigh the evidence and determine the truth of the matter but to determine whether there is a genuine issue for trial." Anderson v. Liberty Lobby, Inc., 477 U.S. 242, 249 (1986).

B. Is The Agreement an Executory Contract?

Based upon the summary judgment record, it appears the parties agree the Agreement bound one or both parties to three affirmative duties: (1) it obligated Debtor to make payment to Plaintiff, (2) it required Debtor to send an explanatory letter, and (3) it called for both parties to terminate the then-pending litigation with prejudice. Additionally, the parties agree the Agreement contained four restrictive covenants: the Debtor's non-competition agreement, a mutual non-disparagement clause, a mutual non-disclosure of confidential information clause, and the Debtor's non-solicitation clause. Finally, the parties agree the only issue remaining is whether, as a matter of law, the Agreement is executory and capable of rejection under the Code.

Section 365 of the Bankruptcy Code allows the Trustee to reject or assume executory contracts, but it does not define what an "executory contract" is. The courts have applied two "tests" to make this determination: the Countryman test, otherwise known as the "material breach test," and the "functional analysis test." Although the majority of courts utilize the material breach test, neither test is mandated in the First Circuit. It appears the courts in this circuit apply each test, sometimes both tests in tandem. Stevens v. CSA, Inc., 271 B.R. 410, 413 (D. Mass. 2001). The First Circuit has recognized that both tests are utilized, but has not adopted either test. Institute Pasteur v. Cambridge Biotech Corp., 104 F.3d 489, 490 n.2 (1st Cir. 1997); Summit Inv. & Dev.

Corp. v. Leroux, 69 F.3d 608, 610 n.3 (1st Cir. 1995); In re La Electronica, Inc., 995 F.2d 320, 322 n.3 (1st Cir. 1993).[5]

C. The Material Breach (Countryman) Test

The material breach test utilizes the seminal definition of executory contract formulated by Professor Countryman: "'A contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing performance of the other.'" King et al., Collier on Bankruptcy ¶ 365.02[1] (15th rev. ed. 1998), quoting Countryman, Executory Contracts in Bankruptcy, 57 Minn. L. Rev. 439, 446 (1973). According to this definition, only contracts where both parties have not yet substantially performed are executory. Id.

When applying the material breach test, Courts look for unperformed material obligations that, if breached, would excuse the other party from performing. Some courts look to state contract law to define substantial performance to determine if failure to perform constitutes a material breach. See Butler v. Resident Care Innovation Corp., 241 B.R. 37, 43 (D.R.I. 1999). The terms of the Agreement provide that it shall be interpreted in accordance with the laws of the Commonwealth of Massachusetts. Under Massachusetts law "[a] material breach of contract occurs when 'there is a breach of an essential and inducing feature of the contract.'" Teragram Corp. v. Marketwatch.com, Inc., 2004 U.S. Dist. LEXIS 26410 at *14 quoting Lease-It, Inc. v. Mass. Port Auth., 33 Mass. App. Ct. 391, 396 (1992) (internal citations omitted). It is a question of fact, not

[5] The Plaintiff argues the decisions in Institute Pasteur and Summit suggest the First Circuit has adopted the Countryman material breach test. The Court does not agree with the Plaintiff. In both of those cases the parties had agreed that the contracts in question were executory and the First Circuit simply noted their agreement and the existence of the majority and minority positions without adopting either one. In La Electronica, the First Circuit noted the existence of the two tests, but stated that it need not concern itself with the question of whether the contract in that case was executory.

a question of law, whether there has been substantial compliance or material breach. See O'Connell Mgmt. Co. v. Carlyle-XIII Managers, Inc., 765 F. Supp. 779, 783 (D. Mass. 1991). "Whether a breach is material is determined by the circumstances of each case." Boston Hous. Auth. v. Hemingway, 363 Mass. 184, 200 (1973). The Supreme Court of Massachusetts has articulated several factors to determine the materiality of a breach of contract:

> (a) the extent to which the injured party will be deprived of the benefit which he reasonably expected;
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> (b) the extent to which the injured party can be adequately compensated for the part of that benefit of which he will be deprived;
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> (c) the extent to which the party failing to perform or to offer to perform will suffer forfeiture;
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> (d) the likelihood that the party failing to perform or to offer to perform will cure his failure, taking account of all the circumstances including any reasonable assurances; and
>
> (e) the extent to which the behavior of the party failing to perform or to offer to perform comports with standards of good faith and fair dealing."

O'Connell Mgmt. Co. v. Carlyle-XIII Managers, Inc., 765 F. Supp. 779, 783 (D. Mass. 1991).

In this case, both parties agree they have each fulfilled all affirmative duties arising under the Agreement. Nevertheless, the Debtor contends the Agreement is executory because the non-disparagement clause created a continuing, mutual obligation–the obligation not to disparage each other until the end of the contract. The Debtor further asserts that each party's passive obligation to refrain from disparaging the other party rises to the level of an affirmative duty because "reputation" is particularly crucial to professionals in the business of providing marketing and promotional services for automobile dealerships in New England. Accordingly, the Court will limit its material breach analysis to the materiality of the non-disparagement clause.

The Debtor relies on In re Drake, 136 B.R. 325, 328 (Bankr. D. Mass. 1992) to support his contention that a continuing, passive duty to refrain from doing something is equivalent to an active contractual obligation to do a particular thing. The Court finds this argument unpersuasive. In Drake, Judge Hillman applied the functional analysis test to find that an obligation not to compete did not render the contract executory because the primary purposes for rejection–"relieving the estate of burdensome obligations while the Debtor is attempting to recover financially and affecting a breach of contract allowing the injured party to file a claim"–could not be accomplished through rejection of the non-compete contract. Id. Other courts have reached the same conclusion about restrictive covenants under the material breach test. These courts base their holdings on the fact that restrictive covenants create passive not affirmative obligations. See In re Schneeweiss, 233 B.R. 28, 32 (Bankr. N.D.N.Y. 1998) ("An obligation to comply with a restrictive covenant, such as a covenant not to compete, does not constitute a material obligation, and a contract under which one party must refrain from competing is therefore not executory under the Countryman definition of an executory contract."); In re Information Technologies., Inc., 190 B.R. at 748-750 (citing In re Drake, 136 B.R. 325) ("[U]pon examining the Employment Agreement, the Court finds that [the parties'] remaining obligations of confidentiality and non-interference are vestiges of that Agreement that do not rise to a level of material future performance.").

The Agreement was made as part of the resolution of a state court law suit and was the subject of a second state court law suit prior to the commencement of this adversary proceeding. The Agreement, by its own terms, was not confidential. The Agreement appears to have contemplated the immediate resolution of the 2002 law suit together with provisions for certain monetary payments and restriction of solicitation of customers for a short time. Once the affirmative obligations were satisfied by each party, performance under the Agreement was essentially

complete, subject only to restrictions on future actions.

The Court does not find the non-disparagement clause to be material under the standard in O'Connell Mgmt. Co. A breach of the non-disparagement clause would not deprive either party of the benefits reasonably expected under the Agreement nor would it effect a forfeiture. Harm to one party from any breach of the non-disparagement clause could only be compensated through recovery of damages. In any event, the summary judgment record does not disclose any factual allegations concerning a breach of such clause.[3] The Court finds that the non-disparagement clause, a passive restrictive covenant, is not a material provision of the Agreement and that the summary judgment record reveals no dispute over any alleged breaches of that clause. The mere fact a passive restriction on future activity is mutual does not render the Agreement executory under the material breach test.

D. The Functional Analysis Test

The "functional analysis" test was formulated by the Sixth Circuit, in In re Jolly, 574 F.2d 349 (6th Cir.), cert. denied, 439 U.S. 929 (1978). It is intended to invoke the broader purposes of section 365 and the Bankruptcy Act by calling for the court to decide if a contract is executory by conducting an inquiry into whether rejection of the contract would benefit the debtor's estate. Stevens v. CSA, Inc., 271 B.R. 410, 413 (D. Mass. 2001).

Under the functional analysis test, the "critical question . . . is whether rejection of the contract would benefit the debtor's estate." Butler v. Resident Care Innovation Corp., 241 B.R. 37, 44 (D.R.I. 1999) (citing In re Drexel Burnham, 138 B.R. 687 (Bankr. S.D.N.Y. 1992)) (discussing

[3] While the Debtor presented some argument suggesting breaches of the non-disparagement clause in his response to the Plaintiff's opposition to the Debtor's MSJ (Doc. No. 35), the summary judgment record discloses no such factual dispute. This allegation was not a factor in the outcome of this case because cross-motions for summary judgment must be determined based on the summary judgment record. Cowell v. Hale, 289 B.R. 788 (B.A.P. 1st Cir. 2003).

all of the relevant academic articles at length and concluding that the proper analysis is whether rejection will confer a benefit on the estate). The Debtor failed to present any argument that demonstrates how rejecting the Agreement would benefit the estate and the Court cannot find any such benefit. Instead, the Debtor merely presented the ways he personally would benefit from a rejection. Therefore, under the functional analysis test, the Agreement is not rendered executory because the bankruptcy estate would not benefit from a rejection of the Agreement. See In re Schneeweiss, 233 B.R. at 32 (citing In re Bluman, 125 B.R. 359, 363 (Bankr. E.D.N.Y. 1991)).

IV. CONCLUSION

For the reasons discussed in this opinion, the Court concludes, as a matter of law, that the Agreement is not an executory contract under either the material breach test or the functional analysis test. Accordingly, the Court need not decide which test is the proper test to apply. Since the Agreement is not an executory contract, it may not be rejected under the provisions section 365 of the Bankruptcy Code. Accordingly, the Court shall enter a separate order granting Plaintiff's MSJ and denying Debtor's MSJ with respect to Count I of the complaint.

This opinion constitutes the Court's conclusions of law in accordance with Federal Rule of Bankruptcy Procedure 7052.

ENTERED at Manchester, New Hampshire.

Date: March 28, 2005

/s/ J. Michael Deasy
J. Michael Deasy
Bankruptcy Judge